

# Accelerated Depreciation for Housing Rehabilitation

Buried deep in the Tax Reform Act of 1969 is another in a lengthening series of provisions aimed at providing better low and moderate income housing in the United States. Section 167(k) of the Internal Revenue Code is an accelerated depreciation provision which allows investors to write off rehabilitation expenditures over a sixty-month period.<sup>1</sup> Because other changes in depreciation rules within the Reform Act make real estate ventures less useful as tax shelters,<sup>2</sup> Section 167(k)

1. The full text of Section 167(k) is as follows:

**(k) DEPRECIATION OF EXPENDITURES TO REHABILITATE LOW-INCOME RENTAL HOUSING.—**

(1) **60-MONTH RULE.**—The taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to compute the depreciation deduction provided by subsection (a) attributable to rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969, and before January 1, 1975, under the straight line method using a useful life of 60 months and no salvage value. Such method shall be in lieu of any other method of computing the depreciation deduction under subsection (a), and in lieu of any deduction for amortization, for such expenditures.

(2) **LIMITATIONS.**—

(A) The aggregate amount of rehabilitation expenditures paid or incurred by the taxpayer with respect to any dwelling unit in any low-income rental housing which may be taken into account under paragraph (1) shall not exceed \$15,000.

(B) Rehabilitation expenditures paid or incurred by the taxpayer in any taxable year with respect to any dwelling unit in any low-income rental housing shall be taken into account under paragraph (1) only if over a period of two consecutive years, including the taxable year, the aggregate amount of such expenditures exceeds \$3,000.

(3) **DEFINITIONS.**—For purpose of this subsection—

(A) **REHABILITATION EXPENDITURES.**—The term 'rehabilitation expenditures' means amounts chargeable to capital account and incurred for property or additions or improvements to property (or related facilities) with a useful life of 5 years or more, in connection with the rehabilitation of an existing building for low-income rental housing; but such term does not include the cost of acquisition of such building or any interest therein.

(B) **LOW-INCOME RENTAL HOUSING.**—The term 'low-income rental housing' means any building the dwelling units in which are held for occupancy on a rental basis by families and individuals of low or moderate income, as determined by the Secretary or his delegate in a manner consistent with the policies of the Housing and Urban Development Act of 1968 pursuant to regulations prescribed under this subsection.

(C) **DWELLING UNIT.**—The term 'dwelling unit' means a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis.

Tax Reform Act of 1969, Pub. L. No. 91-172, § 521(a), 83 Stat. 651 (1969).

2. The Tax Reform Act makes a number of important changes in the tax treatment of Section 1250 property. Depreciation on new non-residential property is restricted to a method which will not produce an allowance in the first two-thirds of the property's estimated useful life in excess of the amount that would be produced by the use of the 150 per cent declining balance method. Used residential property with a useful life of twenty years or more may be depreciated by a 125 per cent declining balance method. All other used real property is limited to straight line depreciation.

should attract the attention of tax-conscious investors. But unless the section is administered with an understanding of the market forces which will influence its operation, it will fail to realize its fullest potential contribution to the satisfaction of the nation's pressing housing needs.

Despite its inobtrusive placement in the midst of more controversial changes in the tax law,<sup>3</sup> the housing assistance program created by Section 167(k) is noteworthy as the first major housing program to utilize tax incentives,<sup>4</sup> as the first major housing program to concentrate on rehabilitation,<sup>5</sup> and as a program whose great potential cost rivals

All new Section 1250 property, including rehabilitated housing qualified for fast depreciation under Section 167(k), is subject to strict recapture provisions. Nonhousing property is denied the one per cent per month phase out of recapture. Residential property is permitted to begin the phase out only after it has been held for 100 months. *Id.*

The changes in the recapture rules are not to apply in the case of federally assisted projects (such as FHA Section 221(d)(3), *see note 38 infra*, and 236, *see note 37 infra*, programs) or other publicly assisted housing programs under which the return to the investor is limited on a comparable basis. These programs have in reality depended heavily on tax benefits, *see, e.g., THE REPORT OF THE PRESIDENT'S COMMITTEE ON URBAN HOUSING, A DECENT HOME 82-84, 238-39 (1968)*. [hereinafter cited as *A DECENT HOME*].

For a numerical comparison of depreciation allowances produced by various methods *see L. WINNICK, RENTAL HOUSING OPPORTUNITIES FOR PRIVATE INVESTMENT 148-49 (1958)*; *see also U.S. NAT'L COMM. ON URBAN PROBLEMS, THE FEDERAL INCOME TAX IN RELATION TO HOUSING Table 3, at 46 (1968)* [hereinafter cited as *THE FEDERAL INCOME TAX*]; *Sunley, The Present Value of Depreciation Allowances, 9 Q. REV. OF ECON. & BUS. 77-79 (1969)*.

3. The predominant issues were taxation of foundations, reduction of the percentage depletion allowance, and alleviation of the tax burden imposed on low income families. *See, e.g., 115 CONG. REC. 6968-7018 (daily ed. Aug. 6, 1969)*; (debate on H.R. 13270 by the House and a Committee of the whole) *id.* at 7073-7151 (daily ed. Aug. 7, 1969) (similar discussion).

4. But of course nearly all housing assistance programs have depended upon the tax shelter principle inherent in depreciation provisions. *See, e.g., A DECENT HOME 83, 238-39.*

5. With a few relatively small exceptions, *see note 6 infra*, earlier programs emphasized new construction, in part on the "trickle down" theory, and in part on the theory that new construction would add to the total standing stock of housing while rehabilitation would not. Even as recently as 1968, Congress carefully restricted the Section 235 homeownership program (*see notes 36 & 37 infra*) by limiting its applicability to rehabilitation of existing dwellings: only 25% of the first year's contracts, 15% of the next year's, and 10% of the third year's could be used for rehabilitation of existing housing. But recently Congress has indicated that rehabilitation should be further encouraged by increasing these percentages, *Housing and Urban Development Act of 1969, P.L. 91-152, § 109, 83 STAT. 381 (1969)*.

Rehabilitation should be less expensive than new construction, assuming equal durability. The Department of Housing and Urban Development has estimated that under Section 236 of the National Housing Act the average cost of an equivalent rehabilitated unit will be only \$11,300. *Hearings on Housing and Urban Development Legislation of 1968 Before the Subcomm. on Housing and Urban Affairs of the Sen. Comm. on Banking and Currency, 90th Cong., 2d Sess. 1320, 1349 (1968)*. *See also Hearings on Housing Legislation of 1967 Before the Sen. Comm. on Banking and Currency, 90th Cong., 1st Sess. 12-13, 95-111 (testimony of Sec'y Weaver)*; *A DECENT HOME 101*; *Schuster, Rehabilitation: A Matter of Time and Money, 33 J. PROP. MGMT. 251 (1968)*.

In addition to saving in direct construction costs, rehabilitation should require less sacrifice of tax revenues derived by local governments from real property taxes. Programs which require demolition and clearance frequently involve the removal of taxable property for considerable periods of time. *See Anderson, The Federal Bulldozer in URBAN RENEWAL: THE RECORD AND THE CONTROVERSY 498-99 (J. Wilson ed. 1966)*.

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that of previous direct expenditure programs.<sup>6</sup> But unlike the long, complex, and detailed statutes which have created direct expenditure programs of similar magnitude,<sup>7</sup> Section 167(k) is brief and categorical. There are three central requirements for receiving benefits under the section: (1) expenditures must be for rehabilitation; (2) rehabilitated dwellings must be held for rental to low and moderate income tenants; (3) depreciable rehabilitation expenditures must aggregate, within two consecutive years,<sup>8</sup> between \$3,000<sup>9</sup> and \$15,000<sup>10</sup> per unit. The

The fact that rehabilitation is generally recognized to be less expensive than new construction of low rent units (*see, e.g.*, A DECENT HOME 108-10) tends to dispel fears that the unique nature of each rehabilitation project makes the technique unsuitable for providing housing. Moreover, if inefficiencies are built into the HUD estimates, experience acquired through utilization of Section 167(k) could lead to their elimination and to enlargement of cost advantages now ascribed to rehabilitation. *See Hearings on S.1354 Before the Subcomm. on Housing of the Sen. Comm. on Banking and Currency*, 89th Cong., 1st Sess. 282, 285 (1965).

6. The House and Senate reports on H.R. 13270 estimate that \$15 million of tax revenue will be lost in the first year of operation and that in 1974 \$200 million will be lost as a consequence of Section 167(k). If the program is continued, it will result in a revenue loss of \$330 million in 1979. H.R. REP. NO. 413 (Pt. 1), 91st Cong., 2d Sess. 16 (1969). The estimate must be subject to considerable variability, *see* TAN 16-18 *infra*.

Other rehabilitation programs have involved relatively insignificant amounts. Rehabilitation grants under Section 115 of the Housing and Urban Development Act of 1965, 42 U.S.C. § 1466 (Supp. III 1967), had totalled \$6.3 million as of Dec. 31, 1967. At the same date section 312 loans, 42 U.S.C. § 1452(b) (Supp. III 1967), totalling \$14.1 million had been extended to finance rehabilitation in federally aided urban renewal and concentrated code enforcement areas. U.S. DEPT. OF HOUSING & URBAN DEVELOPMENT HUD 3d ANNUAL REPORT 27 (1967). The Section 221(h) program—for the purchase and rehabilitation of housing by nonprofit organizations for resale to low income purchasers—had insured below market interest rate mortgages on 73 projects totalling about \$7 million. *Id.* at 19.

Under Section 221(d)(3), the largest housing program for low and moderate income families, the FHA insured over \$1 billion in below market interest rate mortgages during the six year period from 1961 to 1967, an average of almost \$200 million per year. *Id.* Authorizations for Sections 235 and 236 have been large, but only relatively small amounts have been appropriated. Both of these programs can be used for rehabilitation, although they are directed primarily toward the production of new housing.

7. *See, e.g.*, 42 U.S.C. § 1415 (1937) (public housing); 12 U.S.C. § 17151 (Supp. III 1967) (moderate income rental and homeownership). The rehabilitation programs have not been so long and detailed, but they have been strictly limited in scope. *See* 42 U.S.C. § 1452(b) (Supp. III 1967) (rehabilitation loans for urban renewal areas); 42 U.S.C. § 1466 (Supp. III 1967) (rehabilitation grant program).

8. Since many single rehabilitation projects which span more than one calendar year might otherwise be denied Section 167(k) treatment when less than \$3,000 is spent in each year, the statute allows consolidation of consecutive years. It may also be possible to use the two year provision to obtain Section 167(k) treatment for separate rehabilitation items done in consecutive years which would not otherwise meet the minimum expenditure requirement.

The section is restricted to capital expenditures. Since other expenditures are currently deductible, *Inv. Rev. Code of 1954*, § 162(a), this restriction is self-policing.

9. Since there is no indication in either the bill itself or the accompanying House Report that Section 167(k) is designed only to subsidize *substantial* rehabilitation, the purpose of the \$3,000 threshold is probably to avoid the expenses of administration in cases where the subsidy is unlikely to be exceeded by administrative costs. The threshold technique was used throughout the House bill. *See, e.g.*, H.R. 13270, §§ 211, 221, 302, 91st Cong., 1st Sess. (1969).

It has been suggested, however, that the first small increment of money spent on rehabilitation may be more important to the restoration of habitability than further expen-

third of these requirements is but a qualification of the first. Fundamentally, there are two requirements for Section 167(k) treatment: expenditures must be for rehabilitation, and the rehabilitated units must be held for rental to low and moderate income families.

If only the requirement of rehabilitation were present, the scope and impact of the housing program created by Section 167(k) would be subject to considerable uncertainty. The word "rehabilitation" is of uncertain meaning and cannot easily be distinguished from renovation, remodeling, redecorating, and even some kinds of maintenance. Many improvements—ranging from those which raise seriously defective housing to a modest but decent level to those that add luxuries to sound housing—could conceivably qualify. Although "rehabilitation" may imply a prior condition of deterioration or dilapidation, thus limiting Section 167(k) to improvements of dwellings which have fallen below some minimal standard, the section articulates no such standard. While the urgent national concern for urban problems may indicate that Congress was concerned with encouraging non-luxury improvements, the legislative history of Section 167(k) is sparse. The report accompanying H.R. 13270, which describes in fair detail the legislative objectives of most Reform Act changes, limits itself to the simple statement that "[y]our committee bill also recognizes the importance of rehabilitation of buildings for low-cost rental housing."<sup>11</sup> Nothing can safely be concluded from that oracular statement of legislative intent, and there are no other references to the provision—even in the hearings before the House Ways and Means Committee,<sup>12</sup> which

ditures. See generally Quirk & Wein, *Home-ownership for the Poor: Tenant Condominiums, the Housing and Urban Development Act of 1968, and The Rockefeller Program*, 54 CORNELL L. REV. 811, 826 (1969) (suggesting that a program of minimal rehabilitation might be preferable to a program of substantial rehabilitation).

10. The \$15,000 maximum is designed to prevent very expensive "Georgetown" rehabilitation, according to the Treasury's interpretation. Letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, dated Feb. 2, 1970, on file at the Yale Law Journal. But luxury improvements are not precluded by the \$15,000 limit, and could often qualify in the absence of a restriction to families of low and moderate income, see TAN 32 *infra*.

11. H.R. REP. NO. 413, *supra* note 6, at 167.

12. *Hearings Before the House Committee on Ways and Means on the Tax Reform Bill of 1969* (H.R. 13270), 91st Cong., 1st Sess., pt. 8 (1969).

Several witnesses did refer to the possibility of tax incentives for rehabilitation of low cost housing. See, e.g., Testimony of Jason R. Nathan, Administrator, Housing and Development Administration, City of New York, in support of tax incentives as a policy to alleviate urban ills, *id.* at 2809-10. Jerard M. Gross of the National Apartment Ass'n testified in favor of Rep. Boggs' bill, H.R. 3658, which would have allowed rehabilitation expenditures to be deducted currently, *id.* at 2748-70. Robert H. Pease of the Mortgage Bankers Ass'n of America suggested that accelerated depreciation for rehabilitation expenditures is absolutely essential, *id.* at 2770, 2773-79. But no testimony directed to the form of allowance embodied in Section 167(k) was adduced.

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first suggested the program.<sup>13</sup> The rehabilitation requirement appears to provide inadequate guidance for formulating the Section 167(k) program.

The most critical decision in the administration of Section 167(k) will therefore involve the second of its definitional requirements—establishing the maximum income level<sup>14</sup> allowed for tenants of eligible dwelling units, a task which the section assigns to the Secretary of the Treasury.<sup>15</sup> The income ceiling will determine the total amount of lost taxes resulting from the program (*i.e.*, the aggregate amount of government subsidy), the income level of those whom it directly benefits, and the nature of the housing improvements which it encourages.

Because the cost of rehabilitation, reduced by the amount of tax remissions, must be passed on to eligible tenants, the ceiling will affect the willingness of private investors to take advantage of the programs, and thus the resources diverted into it. Establishing too low a level of income eligibility could render the program wholly ineffective. Were eligible tenants restricted to those of lowest income,<sup>16</sup> few could afford the substantially increased rentals which would result from

13. The legislative genesis of section 167(k) is obscure. In 1968 Senator Javits introduced S. 1199, 90th Cong., 1st Sess., a similar provision and perhaps a predecessor of Section 167(k). The Javits bill is analyzed in *THE FEDERAL INCOME TAX*, *supra* note 2, at 81. But in the Reform Act year the program appears to have originated with Rep. Mills' committee.

14. An income standard of eligibility is assumed in this Note. Either an income standard or a rental standard could be used without doing violence to the statutory language, but an income standard avoids the possibility of occupancy by high income families who choose to minimize their housing expenditures, though they are not compelled to do so by limited means.

A rental standard might be simpler to administer and would avoid vexing difficulties encountered under an income standard when a tenant's income rises to exceed the permissible maximum under Section 167(k). In addition, a rental standard would involve a less complete disclosure of financial affairs by the tenant, an attribute of income standards which has disturbed some commentators, *see, e.g.*, Handler & Rosenheim, *Privacy in Welfare: Public Assistance and Juvenile Justice*, 31 *L. & CONTEMP. PROB.* 377-92 (1966); Note, *Privacy and Efficient Government: Proposals for a National Data Center*, 82 *HARV. L. REV.* 400 (1968). Of course, if disclosure were made directly to the Internal Revenue Service, or if the tenant's tax returns were used as a source of information, no governmental probing into personal financial affairs would be added by an income standard.

The characteristics of Section 167(k) examined in this Note are not dependent upon the adoption of an income standard. There is a strong relationship between income and ability to pay rent which justifies the conclusions made in this Note regardless of the kind of standard. *See generally*, A DECENT HOME 41-43. Difficulties stemming from regional differences in monetary standard of living, which have plagued other housing programs, are not considered here. *See, e.g.*, *Hearings on Housing and Urban Development Legislation of 1969 Before the Subcomm. on Housing and Urban Affairs of the Sen. Comm. on Banking and Currency*, 91st Cong., 1st Sess. 53-54 (Statement of Senator Javits indicating failure of programs under the 1968 Housing Act in high cost areas); *id.* at 38-39 (statistics showing marked predominance in southern regions of housing built under Sections 225 and 236 of the National Housing Act).

15. *INT. REV. CODE OF 1954* § 167(k)(3)(B).

16. *See* p. 970 and note 39 *infra*.

even the smallest rehabilitation expenditure qualifying under the section.<sup>17</sup> At this level, participation would be economically impractical. As the ceiling is moved higher, an increasing amount of tax revenue will be lost as a consequence of a more widespread utilization of the subsidy. Since resources for rehabilitation are not unlimited in the short run,<sup>18</sup> at high eligibility ceilings demand created by the subsidy may cause inflationary price increases.

The maximum permissible level of tenant income under Section 167(k) will directly influence the apportionment of the subsidy among different levels of society. The ceiling will not only deny benefits to those whose incomes are higher than the maximum; it will also fail to ensure that benefits will reach those whose incomes fall much below it. For several reasons, one can predict a tendency for Section 167(k) projects to serve tenants whose incomes cluster just beneath the ceiling.<sup>19</sup> First, landlords will find it more attractive to use the allowance to benefit tenants of higher income. Landlords believe that renting to higher-income tenants reduces the real depreciation rate at which the market value of property diminishes.<sup>20</sup> Since the economic value of

17. For example, a \$3,000 rehabilitation will require a significant increase in monthly rental. Taking as a general rule of thumb that rent equal to one per cent of capital value is required monthly, and assuming that all tax benefits are passed on to the tenant, a \$3,000 expenditure will require \$17.50 additional monthly rent if his landlord is in the 25% tax bracket. If his landlord is in the 15 per cent bracket, \$24.75 additional rent will be required. This relationship is particularly important since dwellings occupied by low income families are not often owned by wealthy landlords, see note 27 *infra*.

Some authorities contend that tenants in slum dwellings are adverse to rehabilitation programs because rents may increase. See, e.g., *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 5 at 4906 (Statement of Charles Davenport).

18. See p. 968 *infra*.

19. The allocation process discussed here assumes rational decision-makers pursuing a goal of after-tax profit maximization. For example, an individual landlord who owns three properties is expected to rehabilitate first that property which will provide the greatest return on his expenditure. Similarly, an investor contemplating a number of rehabilitation prospects is expected to buy first the property offering the greatest potential return. As a result, in the aggregate of all properties eligible for rehabilitation under Section 167(k), those promising the highest return will be rehabilitated first. The decision-making process continues in an iterative manner until the return on a potential rehabilitation is not sufficient to attract an investment. See generally H. Bleman & S. Smidt, *THE CAPITAL BUDGETING DECISION* ch. 2. Real estate investors usually require a 15% after tax rate of return. A DECENT HOME 83.

There are two factors which could disrupt this model of the rehabilitation decision-making process. First, there are a substantial number of small landlords who may be unaware of more promising unfulfilled rehabilitation prospects than the one offered by their properties, so that they simply make a sub-optimal decision to rehabilitate their own properties. The significance of this market imperfection is reduced by the fact that Section 167(k) may be used more often by wealthy landlords or investors than by the small single property owner. See p. 968 *infra*. Second, the fact that the tax deduction is more valuable to high bracket taxpayers could distort the decision-making process by making the owner's tax bracket an influential factor. However, each individual high bracket taxpayer views his alternatives assuming a constant marginal tax rate, so he will choose the alternative promising the highest return. Therefore, in the aggregate, properties promising the highest return should be rehabilitated first.

20. This is the accepted view among real estate operators, although most published

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accelerated tax depreciation is measured by the difference between the rate of depreciation allowed for tax purposes and the real rate,<sup>21</sup> the slower real depreciation of higher-income property increases the value of the tax incentive. Second, experience indicates that it will be easier to obtain financing for projects aimed at the high end of the permissible income range. Financing "home improvements" for middle and upper income families has been a lucrative business for banks and other mortgage lenders,<sup>22</sup> but rehabilitation financing for low income families has been very difficult to find.<sup>23</sup> Third, construction techniques and architectural devices already familiar to contractors and developers will be applicable to projects aimed at the high end of the permissible income range, but far less applicable as the projected tenant income declines.<sup>24</sup> Fourth, properties cheap enough for rehabilitation into units for rental to low income tenants may often be located in

statements make the point indirectly. *See generally* Stevens, *The Many Methods Used in Wise Residential Tenant Selection*, 31 J. PROP. MGMT. 39 (1966); *cf.* C. Abrams, *THE CITY IS THE FRONTIER* 187-89 (1965); Klumb, *Management Problems*, 32 J. PROP. MGMT. 93 (1967); STERNLEIB, *THE TENEMENT LANDLORD* 73-75 (1966).

This view is supported by persuasive evidence at the extremes. For example, deterioration has sometimes been incredibly rapid in public housing projects. Within five years of construction a public housing project in Springfield, Massachusetts, had reached a stage of advanced deterioration. *Hearings on Housing and Urban Development Legislation of 1969 Before the Subcomm. on Housing and Urban Affairs of the Sen. Comm. on Banking and Currency*, 91st Cong., 2d Sess. 21-24 (1969).

Since number of children, education, and income are each related to the probability of tenant abuse (and, conversely, to the possibility of creating a "premium rent" building), it would be difficult to relate income alone to the actual rate of deterioration. For a somewhat confused statement by landlords on this subject see STERNLEIB 73-75.

21. Taubman & Rasche, *Economic and Tax Depreciation of Office Buildings*, 22 NAT'L TAX J. 334, 335-36 (1969).

The differential in subsidy between middle-income and low-income units would be doubly great if the latter were generally depreciated over shorter useful lives than the former, since the contraction in allowable useful life would be greater for middle-income units. At least one authority maintains that low-income units are depreciated over shorter lives. Sporn, *Some Contributions of the Income Tax Law to the Growth and Prevalence of Slums*, 59 COLUM. L. REV. 1026, 1037 (1959). Since "the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business . . . determined by reference to his experience with similar property taking into account present conditions and probable future developments," Treas. Reg. § 1.167(2)-1(b) (1956), Sporn's view is probably correct, especially for large landlords owning many low-income buildings from which to derive depreciation data. But even for landlords who simply rely on generalized guidelines, *see* REV. PROC. 62-21, 1962-2 CUM. BULL. 418, 419-20, the subsidy is greater for buildings with a longer real useful life. *See generally* Taubman & Rasche, *supra*.

If administrative considerations were set aside, a truly "neutral" fast depreciation scheme would appropriately adjust the useful life of rehabilitated property as a function of the income level of tenants. As tenant income declined, useful life would also be allowed to decline. The complexity of such adjustments makes them unsuitable for incorporation into tax subsidy expenditures, although expenditure programs can and do make equivalent adjustments.

22. *See, e.g.*, D. HAYES, *BANK LENDING POLICIES* 171-72 (1964).

23. *See* Hearings, *supra* note 5, at 285-86; *see also* A DECENT HOME 96-97.

24. *See* note 31 *infra*.

deteriorating neighborhoods.<sup>25</sup> Investors have been reluctant to attempt rehabilitation in decaying urban areas, because of the fear that general neighborhood deterioration will exert a depressing effect on rentals and property values.<sup>26</sup> Finally, the subsidy will be greater and hence more attractive for units serving higher-income tenants to the extent that owners of such units are more prosperous than those who rent to lower income tenants,<sup>27</sup> because tax incentives become more valuable as the income of the taxpayer increases.<sup>28</sup>

Few would object to adopting a relatively high eligibility level<sup>29</sup> if all families and individuals with incomes below that maximum could be expected to benefit. But were one to establish a high ceiling—perhaps at or near the median income level—there is every reason to believe that many most in need of housing would go unassisted. Millions of families and individuals are to be found at incomes slightly below the median.<sup>30</sup> Section 167(k) projects would focus first on them, absorbing all the capital available for rehabilitation.<sup>31</sup>

25. See generally B. Freiden, *THE FUTURE OF OLD NEIGHBORHOODS* 73-103 (1964).

26. See generally A DECENT HOME 104-05; McFarland, *Residential Rehabilitation Essays* in *URBAN LAND ECONOMIES* 127-28 (L. Grebler ed. 1966); Quirk, Wein & Gomberg, *A Draft Program of Housing Reform—The Tenant Condominium*, 53 *CORNELL L. REV.* 361, 372 (1968).

Apparently the Treasury is aware of these problems. In a letter describing the background of Section 167(k) the Assistant Secretary's office indicated that the program was designed "to prevent continued decay and abandonment of older problems in urban areas." Letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to the author, on file in the offices of the Yale Law Journal. For a good description of the abandonment problem see *NEWSWEEK*, Jan. 12, 1970, at 36.

27. Sternleib's study of Newark's slum areas indicates that a substantial proportion of slum properties are owned by local small owners with less than three properties. STERNLEIB, Exhibit 6-1, at 123. Comparative data on ownership of middle income rental properties would be helpful.

28. For a good presentation of the relationship between income and subsidy under Section 167(k) see *Hearings on H.R. 13270 Before the Sen. Comm. on Finance, 91st Cong., 1st Sess.*, pt. 5, at 4906 (Statement of Charles Davenport).

29. One such standard would be the income limitations established for Section 221(d)(3). See note 38 *infra*.

30. In 1967 there were approximately 48.9 million families in the United States. Roughly one-quarter of all families (24.3%) fell in the income group from \$7,000-9,999 which contains the median; about one-sixth (16.1%) fell in the group from \$5,000-6,999 immediately below the median. *STATISTICAL ABSTRACT OF THE UNITED STATES* 323 (1969). The statistics for unrelated individuals show a similar distribution. More recent statistics for "households" (*i.e.*, families and individuals aggregated) can be found in U.S. Bureau of the Census, *Current Population Reports: Consumer Income*, Series P-60 (annual).

31. Not only is the total amount of manpower and resources available for construction limited, but rehabilitation is even more severely limited than other aspects of the construction industry:

To carry out housing rehabilitation successfully requires a specialist and, because of the special and varied implications of the job, a professional of that type is, at the present time, still a rather rare species. . . . It may be safely assumed that, at the present time, 9 out of 10 contractors are not qualified or willing to [undertake a rehabilitation project].

*Hearings on S. 1354 Before the Subcomm. on Housing of the Senate Comm. on Banking and Currency, 89th Cong., 1st Sess.* 282, 285 (1965) (Statement by the General Improvement Contractors Association).



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The income ceiling, finally, will affect the nature of the rehabilitation which is undertaken. As noted above, landlords will be forced to limit their expenditures, after the cost reduction which the tax incentive will permit, to those that tenants will be able to afford. Although it may be that substantive checks will be imposed on the kinds of expenditures sanctioned by the section,<sup>32</sup> the Treasury could, for administrative convenience, construe the section as applying to *any* capital expenditures between \$3,000 and \$15,000 over two consecutive years, reviewing only the incomes of the tenants. Since rental units occupied by higher income families are already endowed with the standard amenities, it is likely that their rehabilitation would involve the addition of luxury items. If the program were to reach the median family income, it might serve to subsidize the installation of all-electric heat in dwellings never noted for their lack of adequate heat, or the addition of third bathrooms to units already graced with two.

The method which Section 167(k) provides for establishing the ceiling on tenant income should be employed with these considerations in mind. The section directs the Secretary of the Treasury to determine eligibility "in a manner consistent with the *policies* of the Housing and Urban Development Act of 1968."<sup>33</sup> The 1968 Housing Act was an omnibus bill which created several new direct expenditure programs and which also made important changes in then-existing government housing assistance programs.<sup>34</sup> There are many difficulties in determining eligibility levels for Section 167(k) by referring to the policies of a prior omnibus statute providing another form of subsidy administered by a different executive department. The only express policy of the 1968 Housing Act is a reiteration of Congress's intent to keep its sights on a distant star—"a decent home and suitable living environment for every American family."<sup>35</sup> From this evidence, low and moderate income tenants could be defined as those who do not enjoy incomes sufficient to provide decent housing, whatever that worn standard means. If Congress intended for the Secretary of the Treasury to look only to *express* statements of policy in the 1968 Housing Act, it might simply have instructed the Secretary to apply Section 167(k) to families whose incomes are not sufficient to provide "decent" housing. In the absence of such instruction, the Secretary should seek more guidance from the policies implicit in the housing assistance programs created by the Act.

32. See p. 964 *supra*.

33. INT. REV. CODE OF 1954, § 167(k)(3)(B).

34. Pub. L. No. 94-448, 82 Stat. 476 (1968).

35. *Id.* § 2.

A closer examination of the 1968 Housing Act can indeed sharpen the standard by which Section 167(k) should be governed. That Act created three new housing programs. Two of them were the widely-heralded Section 235 home-ownership program<sup>36</sup> and the Section 236 rental housing program.<sup>37</sup> Both have roughly the same eligibility standards: they are designed to assist families whose incomes fall between the level traditionally eligible for admission to public housing and the minimum income served by Section 221(d)(3).<sup>38</sup> Sections 235 and 236 are manifestations of a new congressional emphasis on serving families with incomes lower than those of families previously assisted under low and moderate income programs.<sup>39</sup> Consistent with this view is the statement of the House Committee on Banking and Currency that Sections 235 and 236 "are to be administered so as to accord a preference to those families whose incomes are within the lowest practicable limits . . . under [these] section[s]."<sup>40</sup> While a finding that

36. 12 U.S.C. § 1715Z (Supp. IV 1969).

37. 12 U.S.C. § 1715Z-1 (Supp. IV 1969). For a description of the Section 235 and 236 programs see Quirk & Wein, *Homeownership for the Poor: Tenant Condominiums, the Housing and Urban Development Act of 1968, and the Rockefeller Program*, 54 CORNELL L. REV. 811, 820-32 (1969).

38. Housing Act of 1961 § 101(a)(6), 12 U.S.C. § 1715l(d)(3) (1964). For a description of the Section 221(d)(3) program see Note, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508 (1967). Section 221(d)(3) cannot reach as far down the income scale as Sections 235 and 236 because the latter programs reduce interest rates for assisted families to a minimum of one per cent, whereas the former reduces rates only to three per cent. Originally the Section 235 and 236 programs may have been seen as an extension or modification of Section 221(d)(3), to reach families with less income than those reached by 221(d)(3). Cf. *President's Message to Congress on Housing and Urban Problems*, 114 CONG. REC. 4041 (1968) (message proposing the new programs). But Congress visualized the new programs as separate ones with an impact on families between the incomes eligible for 221(d)(3) and public housing:

Eligibility to participate . . . is limited to families whose incomes do not exceed 135 per cent of the incomes set for admission to low-rent public housing in the area, except that 20 per cent of the funds . . . may be used for families with higher incomes which do not exceed 90 per cent of the limits for 221(d)(3) below market interest rate housing. A deduction of \$300 per child is permitted in determining family income.

HOUSE COMM. ON BANKING AND CURRENCY, 90TH CONG., 2D SESS., SUMMARY OF THE HOUSING AND URBAN DEVELOPMENT ACT OF 1968, at 1.

The formula used for computing income limits for admission to Section 221(d)(3) BMIR projects is detailed in *Hearings on H.R. 5840 and Related Bills Before the Subcomm. on Housing of the House Committee on Banking and Currency, 89th Cong., 1st Sess.* 266 (1965).

39. The third new program, authorizing National Housing Partnerships to attract business investment into housing for low and moderate income families, expresses no new congressional intent regarding what income levels should receive federal housing assistance. Housing and Urban Development Act of 1968 § 902(a), 42 U.S.C. § 3932(a) (Supp. IV 1969). The principal attraction is a provision of the section which assures flow through of depreciation to corporate partners. See Quirk & Wein, *supra* note 37, at 845-46.

40. COMM. ON BANKING AND CURRENCY, HOUSE OF REP., 90TH CONG., COMPILATION OF THE HOUSING AND URBAN DEVELOPMENT ACT OF 1968, SECTION-BY-SECTION SUMMARY 162, 169 (1968).

## Accelerated Depreciation for Housing Rehabilitation

Congress favored helping those families with the lowest incomes which could be reached by each program is not compelled, the inference is reasonable in light of the greater need of the poor,<sup>41</sup> and is supported by legislative materials.<sup>42</sup>

Interpreted in this fashion, the section's reference to the policies of the 1968 Housing Act creates a clearly defined standard with two parts. The income ceiling of families and individuals eligible under Section 167(k) should fall somewhere between the lowest incomes of families which can utilize Sections 235 and 236 and the maximum levels under Section 221(d)(3). This vast range reaches down almost to the level of income served by public housing and up into the area of median family income. The character of the Section 167(k) program will depend substantially on where within this range the income ceiling is placed.<sup>43</sup>

The second part of the standard derived from the 1968 Housing Act requires that the program help families of the lowest income practicable. Since rehabilitation efforts will cluster close to the eligibility maximum, one question must be asked: How far beneath the maximum ceiling can the eligibility limit be set without significantly reducing the number of units that will be rehabilitated? Though the answer to this question is not obvious, the Treasury should, with the help of expert advice or careful econometric analysis,<sup>44</sup> be able to answer it. A proper implementation of Section 167(k) requires that the effort be made.

The merits of tax incentives as devices for encouraging housing production have been questioned. Commentators have pointed out that tax incentives create tax inequities,<sup>45</sup> that they are a form of subsidy offering wealthy individuals opportunities not open to others,<sup>46</sup> and that they are less efficient and less visible than direct expenditures.<sup>47</sup> Passage of Section 167(k) raises still other issues: what result did Congress

41. See, e.g., A DECENT HOME, Table 1-8, at 44; see also U.S. Dept. of Housing and Urban Development, 1967 STATISTICAL YEARBOOK 42; U.S. Code Cong. Admin. News Serv., 90th Cong., 2d Sess. 3038 (1968) (more recent but less precise data).

42. As the income of eligible families is allowed to rise, the expenditure necessary to bring their dwellings to a "decent," level decreases. Hence, more families might be assisted if the income eligibility ceiling were high. See Note, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508, 537 (1967). With respect to Section 167(k), however, Congress appears to have chosen to help a lesser number of families with larger subsidies.

43. See p. 965 *supra*.

44. See, e.g., *Tax Reform Studies and Proposals: U.S. Treasury Department, Part 4* (1969), a technical study of the economic effect of percentage depletion allowances, prepared by CONSAD Research Corp.

45. THE FEDERAL INCOME TAX 5-8; Hearings, *supra* note 41, at 4903-08; Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Expenditures*, 83 HARV. L. REV. 705, 720 (1970); Note, *Government Programs to Encourage Private Investment in Low-Income Housing*, 81 HARV. L. REV. 1295, 1296-99 (1968).

46. See p. 968 and note 28 *supra*.

47. THE FEDERAL INCOME TAX 81-84; *Tax Reform Studies*, note 44 *supra*, at 2.2.

intend, and how can the incentive be administered to achieve that result? If Congress intended to aid low income groups primarily, this goal can best be served by establishing the lowest ceiling consistent with full utilization of the program.

Advocates of tax incentives argue that because tax incentives leave much to the operation of market forces, they are better able to redirect the strength of a private economy than are other subsidies.<sup>48</sup> Yet while keeping the tax incentive unfettered by detailed provisions may harness the strength of private enterprise, it may also direct government largess to unintended recipients or encourage less needed economic activity.<sup>49</sup> To design an effective tax incentive, whether at the legislative or administrative level, the interaction between the subsidy and the numerous uncontrolled market forces affecting its utilization must be understood fully. Section 167(k) will miss the mark if, in setting the ceiling on eligible tenant incomes, the forces which could divert it from its intended effect are not taken into account.

48. To bring the resources of private enterprise to bear on the problems of the slums, it will be necessary to provide a system of incentives and assistance. . . . For it is not out of lack of a sense of responsibility, nor out of disinterest or ignorance, that American business has neglected the city housing problem . . . .

But as David Rockefeller also told the committee, businessmen know of no real way 'in which private enterprise can build and make a profit, even a modest one,' in the building for the lower income families. In the words of a Ford Foundation position paper:

'If private capital is to enter (the slums), new and powerful incentives will be needed to compensate for the obvious economic disadvantages that now exist.'

And, the paper continues:

'Next to an outright guarantee of profits—an undesirable and unlikely alternative—the most effective tools we have so far devised to redirect the flow of private resources are private tax incentives.'

113 CONG. REC. 18823-24 (July 13, 1967) (Remarks of Sen. Robert Kennedy on introducing S.2100, his tax incentive program for encouraging business investment in urban poverty area housing).

Not all commentators have reached the same conclusion as Senator Kennedy. See, e.g., THE FEDERAL INCOME TAX, *supra* note 2, at 97; Surrey, *supra* note 45.

49. See, e.g., *Tax Reform Studies*, *supra* note 44, at 26-27.